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Laws May Change But Japanese Society Does Not

Remarks by
Tetsundo Iwakuni†

My name is Tetsundo Iwakuni. I am a Japanese senior vice president of Merrill Lynch Capital Markets, where I am responsible for providing strategic financing and investment advice to Japanese companies operating in the United States and to U.S. companies going to Japan. I have listened to the presentations by Ms. Peters and the other distinguished speakers this morning and am very impressed and intrigued. I will try my best not to disappoint you after a series of excellent speeches. Unfortunately, to hear the name of Merrill Lynch quoted by a Security and Exchange Commission [hereinafter SEC] commissioner in a discussion of brokerage firm bankruptcy and its impact in Tokyo was not a pleasant way to start a Saturday morning on this peaceful campus, particularly because I was Chairman of Merrill Lynch Japan. At second thought, however, I realized that using the name of the most famous and visible of American investment firms, particularly after a week of record decline on Wall Street, only served to drive home her message more powerfully.

Today, it is my pleasure to address a misconception among Americans and other foreigners who wish to do business in Japan and who wish to be treated fairly by the Japanese government and Japanese companies. The misconception is that changes in the laws will lead to a change in traditional Japanese relationships and Japanese society.

As you may know, the Japanese Finance Ministry has recently agreed to modify certain regulations which have inhibited foreign financial firms from participating in the Tokyo capital market. Financial organizations in the United States and Europe have welcomed this move in the belief that Japan is finally discarding its protectionist stance. Unfortunately, as I will explain to you, that is not the case. In fact, no new laws or modification of regulatory barriers will change Japanese society overnight. In other words, a change on paper does not mean a change in the marketplace.

Japan is not the United States. Here, laws can appear to change society overnight. Perhaps that is because laws in the United States reflect the

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desires of powerful social groups. Attitudes and customs change before laws. Thus, new laws in the United States, including deregulation of American financial markets, reflect the wishes of these groups. This is not so in Japan, where deregulation has been sought from the outside (due to lobbying by foreign firms), not from within, and Japanese society does not want the changes that have been imposed on it.

Nevertheless, Japanese regulatory barriers have been lowered, haven't they? The Tokyo capital market is now more receptive to foreign participation, isn't it? The answer is yes, and no. I say yes because the Japanese, due to the sheer size of the Tokyo capital market and its influence on the world financial system, have recognized the need to appear to be more receptive to foreign firms. I say no because the Japanese will only give rhetorical support to the new regulations. Meanwhile, they will continue to do business among themselves in the way that they have for hundreds of years, a way that sometimes directly conflicts, legally and ethically, with the American business style.

Although American firms such as Merrill Lynch will make inroads into the Japanese financial markets, their gains will be achieved only with great difficulty. As Merrill Lynch has been active in Japan longer than most foreign firms, I will use the Merrill Lynch experience to illustrate the legal and societal barriers that foreign firms have traditionally encountered and must still cope with in Japan today. Since we first opened an office in Tokyo in 1961, we have constantly experienced difficulties in persuading the Japanese government to modify its stance. In each instance, change came grudgingly and only after prolonged negotiations.

For example, in Japan, although some foreign firms had securities licenses, only Japanese firms had been allowed to participate in syndicates, underwriting government bonds. For years, we asked why Japan did not allow foreign underwriters. We tried at length to negotiate permission to participate in underwriting syndicates. Although our persistence cost Merrill Lynch time and money, we finally obtained permission in April of 1984. The percentage of syndicate underwriting given to foreign firms, however, remains very low.

The investment management business provides a second example of Japan's reluctance to change. Looking ahead for the next fifteen years, we at Merrill Lynch see a high potential for growth in this lucrative market and have been eager to participate. As in other instances, the Japanese, while cordially inviting us to join this market, made it very difficult for us to create a subsidiary for this purpose. Because we believed in the market's great potential, we continued to negotiate. Finally, in January of 1986, we received permission to create the wholly-owned subsidiary we had long wanted.

The third example is the controversial Tokyo Stock Exchange [hereinafter TSE] issue. For many years, Merrill Lynch has been the front-runner

among foreign firms seeking a seat on the TSE. In fact, for most of that period, we were the only runner, as our competitors stood by and watched us run the race without success. There are five reasons why we were so persistent about pursuing TSE membership. First, a direct, broader, and deeper access to one of the world's largest stock markets is vital to achieving true global research and trading capability. Second, TSE membership is necessary for qualification as a syndicate member of an initial public offering by a Japanese company.

Third, we projected that, by gaining TSE membership, we would enjoy approximately a forty-five percent increase in the profitability of our Japanese business, which is, in any account, a revenue growth vital to that business. This expected growth in profits would result from the fact that we no longer must pay commissions to TSE member firms. Before getting a stock exchange seat, Merrill Lynch and other foreign firms had to pay a twenty-seven percent commission to local member firms as a fee to pass the orders to the stock exchange floor. Under these conditions, the analysis of our stock trading revenue was not encouraging. For placing an order, we charged individual customers 100 percent of the TSE commission rate, but then had to pay out twenty-seven percent of it. This cost left our net at seventy-three percent. By getting the seat, our revenue of seventy-three percent of the TSE commission rate will increase to 100 percent, a thirty-seven percent increase. Similarly, we charged qualified institutions, whose business is quite important in dollar amounts, eighty percent of the rate and had to pay out twenty-seven percent, leaving us only fifty-three percent. A seat on the TSE means that our revenue of fifty-three percent will become eighty percent, a fifty-one percent increase.

The fourth reason we so vigorously sought TSE membership was that it would better enable us to execute mergers and acquisitions for our U.S. clients. To have first-hand trading and execution capability is essential if Merrill Lynch is to satisfy the needs of its U.S. clients. The alternative is to rely on local brokerage firms who often show their allegiance to the domestic target and/or will not maintain the same discipline in handling inside information that the brokerage firms in the United States must.

Finally, more than fifty U.S. stocks are listed on the TSE, and I believe that Merrill Lynch and other U.S. firms are currently best able to provide quality research on these companies. Further, Merrill Lynch and other U.S. firms can create a market for U.S. companies in the home market, Japan.

Again, our persistence and patience paid off in February of 1986, when, in an epoch-making event, Merrill Lynch was rewarded with the first TSE seat granted to a foreign firm. By gaining that seat, Merrill Lynch became the only firm in the world with full membership in the world's four most important stock exchanges—New York, Tokyo, London, and Toronto. We helped pave the way for the other foreign firms that were awarded seats after

us (Morgan Stanley, Goldman Sachs, and three United Kingdom firms), and for those that will probably acquire seats in the future.

Although there is no question that we have made some noteworthy breakthroughs in Japan, we have had our share of difficult and frustrating experiences. These experiences are symptomatic of the basic problem: just because the Japanese have agreed to break precedent does not mean that actual changes will, in fact, occur.

Let me give an example to illustrate what I mean. About twenty major Japanese securities companies have established accounts with the Bank of Japan, and we first tried to do that in 1984. Despite the fact that Merrill Lynch was the eleventh firm in Japan registered as a general securities company (*sogo shoken*), Japanese authorities denied us a Bank of Japan account. In short, we were not treated like a domestic company, which we most emphatically were, but rather as an outsider. This hardly seemed like a fair and reasonable approach by any standard, so we continued to press our case with the authorities concerned. It took more than two years until Merrill Lynch, as well as another U.S. firm, obtained a Bank of Japan account in August, 1986.

Another example of this ongoing conflict is the still unresolved branch office issue. In 1961, Merrill Lynch applied for, and was granted, permission to open an office in Tokyo. So far, so good. The Japanese had broken precedent, and it appeared that we at Merrill Lynch had gotten what we wanted. In Japan, however, it is not enough just to open up an office (which was easy enough to accomplish). The main reason we wanted an office was to sell securities, for which we needed a securities license. Ten years went by, and it was necessary for Parliament to pass an act before Merrill Lynch could obtain that license. Also, for several years in the 1970s, Merrill Lynch was the only foreign firm to have a branch office in Tokyo.

In the process of this ordeal, we learned a valuable lesson: the Japanese will willingly agree to the concept of free, fair, and open markets but will do whatever they can to place small obstacles in our path in the hope, perhaps, that we will tire and give up.

We did not give up. Soon after obtaining the securities license for our second Japanese branch, in Osaka, we requested permission to upgrade our branch to local company status, such as that enjoyed by Japanese companies in the United States. We were unsuccessful then, and we remain unsuccessful to this day.

Japanese law regards firms without local company status, like Merrill Lynch, as foreign-dominated companies. All firms classified as foreign-dominated must apply for a separate securities license for each new branch. That means that Merrill Lynch may end up with five or six separate licenses as corporate assets in a single country. With so many licenses, Merrill Lynch will be in the *Guinness Book of World Records*. We must go through the same process as companies that are relative newcomers to the Tokyo market. As old-timers in Tokyo, we do not appreciate being placed in the same category

as relatively unknown firms. In addition to the branch problem, local company status would be an advantage in hiring, job title, social prestige, and assurance for local employees and their families.

At Merrill Lynch, we place all our Japanese operations under the umbrella of what we call Merrill Lynch Japan. Without local company status, Merrill Lynch Japan exists only on paper, as it had to be created outside Japan, in Delaware. Under Japanese law, Merrill Lynch Japan does not exist at all. This situation can be compared unfavorably to that of our similarly structured umbrella of Canadian operations, Merrill Lynch Canada, which has been granted local company status by the Ontario Parliament.

The situation in the United States is quite different from that in Japan. Japanese companies only need the approval of the Japanese Minister of Finance, not the U.S. Treasury Department, in order to operate in the United States. It is so easy for Japanese companies to become established in the United States that today twelve have fully operational U.S. subsidiaries. No American companies have subsidiaries in Japan. In this context, the Japanese Ministry of Finance is effectively controlling the two largest capital markets in the world. If this were a baseball game, the score would now be Japan twelve, the United States nothing. A game this one-sided, where one team is so handicapped by the rules as to be unable to compete, is unacceptable to us.

On this issue and other issues related to obtaining a position equal to Japanese firms in Japan, Merrill Lynch has spent an enormous amount of time and money negotiating with the Japanese government and industry organizations. We are fortunate that this experience has enabled us to learn much — maybe too much. We are not so fortunate in that we have realized only a modest reward for our diligence and patience. Does that mean that we are giving up on Japan? No, far from it. But our efforts do need to be more fruitful.

I have been in this business for twenty-nine years — nine years in Japan, eleven in Europe, and nine in the United States — and have continuously commuted between Tokyo and other major foreign markets. In my three decades, I have learned that Japan is, in many respects, a mystery — an enigma — to foreigners who must do business there. Japan, as you know, is a country bound by tradition. It is also a country that has very deep respect for the law. In Japan, when a law passes Parliament, it is supreme, and will not be violated. For that reason, many non-Japanese expect that the enactment of a law will change Japanese society overnight. As I stated earlier, that is a misconception. It fails to realize the very pervasive continuing influence Japanese tradition has on Japanese society. While the Japanese will scrupulously follow the letter of the law, the customary Japanese way of doing business inexorably works to defeat the stated purpose of that law, equal access for a foreign company to Japanese markets.

Let me give you an example of how a new law has not led to a change in the Japanese way of doing things. Merrill Lynch was awarded a seat on the

TSE as a result of a change in the by-laws in 1984. In order to get the most out of that seat, we need to increase our staff and expand our branch network in Japan. Without a larger staff, expansion is difficult. Yet, because of the life-time employment system in Tokyo, we have to make a special effort to attract experienced floor traders and back office operations personnel. But difficulty in hiring staff is only part of the problem. The real problem, once again, is a system of rules and restrictions designed to give only lip service to cooperation with foreign firms.

I would like now to give a few examples of deregulatory changes and to show how these changes in the law are not felt in the marketplace because customs and unspoken local understanding work to defeat them.

One area where Merrill Lynch has encountered obstacles is in the underwriting business. In bond issues, the so-called Samurai bonds, yen-denominated bonds issued by foreign governments and corporations, while not the largest sector of the market, represent the single most important market for foreign firms. Once deregulation gave them access to these issues, firms like Merrill Lynch wanted to participate in this potentially lucrative market sector. Underwriting these bond issues, however, requires that a long-term relationship with the issuing companies be built up over several decades. Japanese lead managers had agreements among themselves that foreign firms could only underwrite five percent of a given Samurai issue. When only five or six foreign firms were licensed in Japan, this situation was tolerable. However, as the number of licensed foreign firms increased to twenty or so, all the originally participating foreign firms saw their market share shrink. Presently, all foreign firms are competing for a piece of pie that grows smaller as more of them appear in the marketplace. Nonetheless, the five percent quota was liberalized only recently.

Likewise in the case of stock offerings, Japanese custom presents an obstacle to foreign participation to a greater degree than with bond issues. In Japan, the appointment of the management and the underwriting positions for stock offerings are largely based on so-called "relationships." These relationships take the form of personal acquaintances, in which the parties eat together, drink together, play golf together, sing together and even hire each other's sons and daughters. On the face of it, these relationships seem harmless enough. Closer examination, however, reveals that these relationships go far beyond friendship. In fact, it is a well-known fact in Japan that these "personal" relationships form the basis for an information-exchange network which quite often results in what we in the United States call insider trading.

Unlike in the United States, the concept of insider trading is not clearly defined in Japan, and the practice is quite common among Japanese firms. Foreign firms thus face a legal and ethical dilemma in trying to build relationships with companies who regard the exchange of inside information as the foundation of personal and business relationships. As a firm which cannot, by law or custom, engage in the exchange of inside information, Merrill

Lynch and other U.S. firms are caught between a rock and a hard place. Although both Japanese issuers and investors admit to being impressed by our capability and professionalism, both are discouraged from employing us as bankers and brokers because we cannot and will not become involved in what we regard as the illegal and unethical exchange of information that is not available to the general public.

Certainly, I expect the Japanese to change this environment quickly and aggressively. Otherwise, foreign firms, particularly U.S. based firms, will be left in a very difficult position due to their need for compliance with SEC and National Association of Securities Dealers regulations. While Japanese firms in the United States obviously adhere to SEC standards, Japanese firms conducting business in Japan do not. This practice places all foreign firms operating in Japan at a distinct competitive disadvantage. In the increasingly important Tokyo market, this failure to comply with accepted SEC standards makes doing business especially difficult for Merrill Lynch and others.

Sales presents another area where laws hinder our ability to compete fairly in Japan. The Japanese require salesmen to have a sales representative license, which is similar to a U.S. representative license. In a system that has not changed much in decades, Japanese salesmen have always handled sales of foreign financial products in Tokyo. Today, with the growth of the Tokyo market, Japanese salesmen are handling more and more foreign products such as treasury bills and U.S. Big Board stocks. Japanese firms allow only salesmen having Japanese licenses to place these foreign securities with Japanese investors.

I complain because Merrill Lynch salesmen, in order to work permanently in Tokyo, are forced to pass both a test in Japanese and, for compliance reasons, a U.S. exam dealing with New York Stock Exchange standards and regulations. Merrill Lynch salesmen in Tokyo must therefore undergo three to four months of training in preparation for the test and then take the Japanese test, in a foreign language. There must be a more efficient method that is fair to all parties. I hope that, in the future, we can find one.

The pension fund business provides a non-Merrill Lynch example of how outside firms, despite meeting all the legal requirements, are gently shunned by potential Japanese customers. After years of campaigning energetically for permission to participate in the pension fund business, nine foreign banks, including Morgan, Chase, Citibank and others, finally won approval from the Japanese government to establish Trust Banks in Tokyo. However, after two years, the result is appallingly disappointing: the foreign banks, despite their size and world-class reputations, have only \$120 million in pension funds to manage between them, accounting for only 0.09 percent of the total market. More embarrassingly, not much hope exists of gaining a larger market share in the near future.

Before I conclude my presentation, I will discuss two aspects of Japanese society which will give insight into why it has been so difficult for foreign

businesses to gain access to Japanese markets: insider trading and the concept of "window guidance."

I have already mentioned that Merrill Lynch is at a competitive disadvantage because we do not indulge in insider trading and we do not use inside information to procure business. Japan, on the other hand, favors the idea of dealing and trading with "friends." Who exactly are "friends," and what is the essence of this concept? I would like to emphasize that the Japanese are a family-minded people. They are products of a small, closed society where those who share the same family ties, the same home town, the same school, or the same company are bound together in all facets of their lives.

The family group, the "friends" concept, is the lifeblood of business dealings in Japan. The shares of Mitsubishi, for example, are held by other Mitsubishi companies. These companies also get most of their important business from members of the same group. The same situation applies to Sumitomo, Mitsui, and others. Therefore, in any financial transaction, each company gives the members of its group priority. Other firms, particularly foreign ones, are left out in the cold.

In this manner, the Japanese have succeeded in incorporating eighteenth century values and relationships into a twentieth century financial system, just in time to enter the twenty-first century. It is a financial system which, unfortunately, acknowledges the concept of fair treatment by passing laws that use the language of cooperation to disguise the old ways of giving preference to "friends."

Can firms like Merrill Lynch ever hope to compete on equal footing with their Japanese counterparts in Japan? The answer is that it can, but only if Merrill Lynch becomes a true "friend" in the Japanese context.

Foreign firms encounter further discrimination via the concept of "window guidance." Window guidance is an unofficial system in which the government, specifically the Ministry of Finance, subtly intervenes in the marketplace to influence business decisions made by Japanese firms. Through inference and implication, whose true meaning and intent is clearly understood only by the Japanese themselves, outsiders are unofficially precluded from full participation in the Tokyo market.

Through bureaucratic sleight of hand, such as the requirement that every branch office of a foreign firm must obtain a separate license, the government masks its intention to maintain a closed, non-competitive financial marketplace. This marketplace remains a nearly perfect reflection of the society that created it.

Breaking the hold of bureaucrats on the business community will be a long process, a process that will not be aggressively pursued until the Japanese business community and Japanese society see the necessity to do so. Until that time comes, and we are confident that it will come, we will see what we have seen in the past, new laws and no change.

Thank you very much.